Weekly Market Insights

March 21, 2022

A market reversal with mounting questions

Financial Markets

This past week, equity markets had their best performance since November 2020. The advance came after the Federal Reserve raised their benchmark rate for the first time since 2018, while peace talks between Russia and Ukraine continued with mixed results. The Dow rose 5.5%, S&P 500 increased 6.2%, and the NASDAQ returned 8.2%.

Economics

Will the global economic landscape significantly change and is the United States looking forward to a prolonged bout of stagflation? How the hostilities between Russia and Ukraine play out is well out of our bailiwick. We spend a great deal of time on the other question. The topic of stagflation has gotten the spotlight since Larry Summer's March 15 *Washington Post* article titled "The Fed is charting a course to stagflation and recession." Larry Summers is a brilliant economist and the former Secretary of the Treasury, so his opinion means a lot. Forecasting is notoriously difficult and involves making assumptions about the future, which may or may not come true. We remind readers of Maynard Keynes' quote, "mathematics is a better describer of economics than predictor." Most economics problems are not like engineering problems in that there is no definitive answer, leaving room for alternative views.

Mr. Summers makes the monetarist's argument that excess liquidity leads to inflation and that the Fed has continued to employ loose monetary policy during a period of high inflation and an already tight labor market. His argument bears a lot of weight since Mr. Summers is a self-described progressive.

The last counterargument anyone wants to hear is "it's different this time." But perhaps it is. The economics behind Mr. Summers' argument are correct, but the circumstances are very different than anything we have experienced in the past. The long duration of the COVID shut down has dealt a unique and devastating blow to the global economy, but it did not occur in a vacuum. The United States and the world were recovering from two economic shocks in one decade. In order for his forecast to become reality, a number of things must be in place. The U.S. labor supply must remain stagnant, COVID-induced supply chains must remain damaged, and new fiscal stimulus must be ineffective.

As the labor supply begins to expand, it will reduce inflationary wage pressures. Also, as supply chains and associated transportation lines come back, half of the equation—too much money chasing too few goods—will get relief. New fiscal stimulus designed to improve U.S. infrastructure, a subject we will review in the next section, may actually reduce inflation while lifting GDP.

Before Russia's invasion of Ukraine, the immediate future of globalism was in doubt. It is well documented how one of the unintended consequences of the invasion has been a powerful reinvigoration of the relationship between the U.S. and many Asian countries. More has been published on the coordination of defense measures, but closer economic ties will follow. As an example, Western Europe has been buying a lot of technology from China, which is now very likely to slow. China, on the other hand, has a slowing

economy for demographic, economic, and political reasons. This is not an ideal environment for China to restrict economic ties with the West. The last thing Xi Jinping needed was to have Russia invade a smaller country and apparently botch the job. Remember the overt show of solidarity during the Olympics. It may not have been as heartfelt as some believed. These two items spur competition, which everyone from Adam Smith to Larry Summers would argue is a governor keeping businesses from raising prices.

As we wrote last week, we expect a large increase in spending on technology and, perhaps more importantly, innovation! William Baumol, the great Princeton economist, titled his now famous book, *The Free–Market Innovation Machine: Analyzing the Growth Miracle of Capitalism*. Technology plus innovation fosters competition, adds productive capacity, lowers costs, and keeps wages in check. Does this guarantee Mr. Summers' argument won't come to fruition and ours will? Of course not, but it is a viable alternative. Perhaps what will happen is some combination of the two.

Conclusion

This paper is meant to point out the difficulty of making forecasts. It is challenging to come to a satisfactory conclusion with so many moving parts. We now have a good window into the Fed's thinking, but it is obviously not set in stone. Clearly, the Fed recognizes we are in a period of elevated inflation, but its actions will depend on the duration and severity of the inflationary cycle. Larry Summers is certainly a brilliant economist, but, like all of us, he is fallible.

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